Independent Television

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July 11, 1995

Mr. William Caton
Office of the Secretary
Federal Communications Commission
1919 M Street N.W.
Washington, D.C. 20554

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JUL 1 1 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

RE: MM Docket No. 94-123
WRITTEN EX-PARTE COMMUNICATION

Dear Mr. Caton:

Enclosed please find the original and copies of a Surrebuttal and Further Econometric Evidence, with appendices, prepared by the Law and Economics Consulting Group, Inc. These documents should be filed in the above captioned proceeding.

These documents were presented to the Mass Media Bureau, Office of Plans and Policy and the Commissioners' offices.

Sincerely,

David L. Donovan
V.P. Legal & Legislative Affairs

enc

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List A B C D E

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**Before the**

# Federal Communications Commission

**Washington, D.C.**

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FEDERAL COMMUNICATIONS COMMISSION
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| In re | ) | |
| | ) | |
| Review of the Prime Time | ) | MM Docket No. 94-123 |
| Access Rule, Section 73.658(k) of the | ) | |
| Commission's Rules | ) | |

**Surrebuttal**
**and**
**Further Econometric Evidence**

**The Economic Effects of Repealing the Prime Time Access Rule: Impact on Broadcasting Markets and the Syndicated Program Market**

Prepared for:
Association of Independent Television Stations, Inc.
King World Productions, Inc.
Viacom Inc.

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**July 7, 1995**

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## EXECUTIVE SUMMARY

- When all is said and done, LECG's finding that PTAR had immediate and dramatic impacts on independent television stations weighs heavily on the impact repeal is likely to have: an immediate and dramatic adverse impact on access period ratings points.

- In their reply comments, Economists Inc. (EI) and Williamson and Woroch (WW) seriously mischaracterize what LECG said, and did not say, in its March 7, Economic Report.

  LECG did control for major structural changes in the market such as cable penetration in estimating its forecast for ratings declines were PTAR to be repealed.

  LECG's model did show ratings impacts from the implementation of PTAR that were significant in the long run as well as the short run.

  LECG's market-based model specification for ratings, together with basic micro theory, was the correct test of incentives for long run entry due to PTAR. WW's model of the individual firm is completely mis-specified as a test of entry.

  LECG's growth equations were not its test of incentives for long run entry, and, contrary to EI's mischaracterization, they do show that long run entry stimulated by PTAR likely began in the early 1980s.

- Our further econometric results show PTAR has had a separate and significant effect on independent stations than the Fox network has had, and that PTAR and network effects are likely mutually reinforcing in improving the competitiveness of independent stations.

- EI falls into the "cellophane trap" in antitrust in falsely maintaining that a decline in aggregate market shares means major network pricing practices are those of a competitive market. EI makes errors in elementary micro theory in claiming secular increases in prime time advertising prices are caused by shifts in demand in a competitive market. Such shifts would induce entry in the long run where there are no barriers to entry, and price would be the same. The price increases LECG reported are consistent with barriers to entry and market power, not a competitive market.

- Contrary to EI's grossly exaggerated claims concerning a $200 billion opportunity cost of PTAR, an analytically sound calculation reveals it to have been no more than $2.3 billion cumulatively to date, and zero in the future. These costs were incurred during the early years of the rule, certainly prior to 1984. Based on Noll, Peck and McGowan estimates of the value of a station, PTAR's benefits far outweigh its costs.

# I. INTRODUCTION

> "Thus although the limits of regulation are manifold, merely to show that regulation is flawed does not establish that regulation is an inferior mode of organizing economic activity. ... [T]here is an obligation to assess the properties of the proposed alternative -- not only in general but also specifically with respect to the activity in question. If the proposed mode is flawed in similar or different respects, the purported advantages of shifting out of regulation may be illusory."

Williamson, Oliver E. (1985), The Economic Institutions of Capitalism, The Free Press, p. 328

> "The "chicken-and-egg" problem means that independent UHF stations cannot take advantage of the economies of transactions costs and large audiences that network-affiliates enjoy, with the result that they are not able to afford very attractive programs."

Bruce M. Owen in Owen, Bruce M., Beebe, Jack H., and Manning, Willard G., Jr., (1974) Television Economics, Lexington Books, p. 123.

In deciding the future of the Prime Time Access Rule, it is important that its merits (and demerits) be examined afresh because:

- The diversity goal of the Rule has been accomplished, not entirely in the way originally envisioned by the FCC through local access period programming on affiliates, but primarily through improved financial viability and growth of the independent television sector:

more channels and newly forming networks built around those channels

- PTAR has worked to ameliorate the market power of the three major networks in the program market, and it has had the socially desirable effect of being pro-competitive and efficiency-enhancing in the national market for prime time network advertising

- PTAR has stimulated the development of the UHF band, as originally intended by the Rule

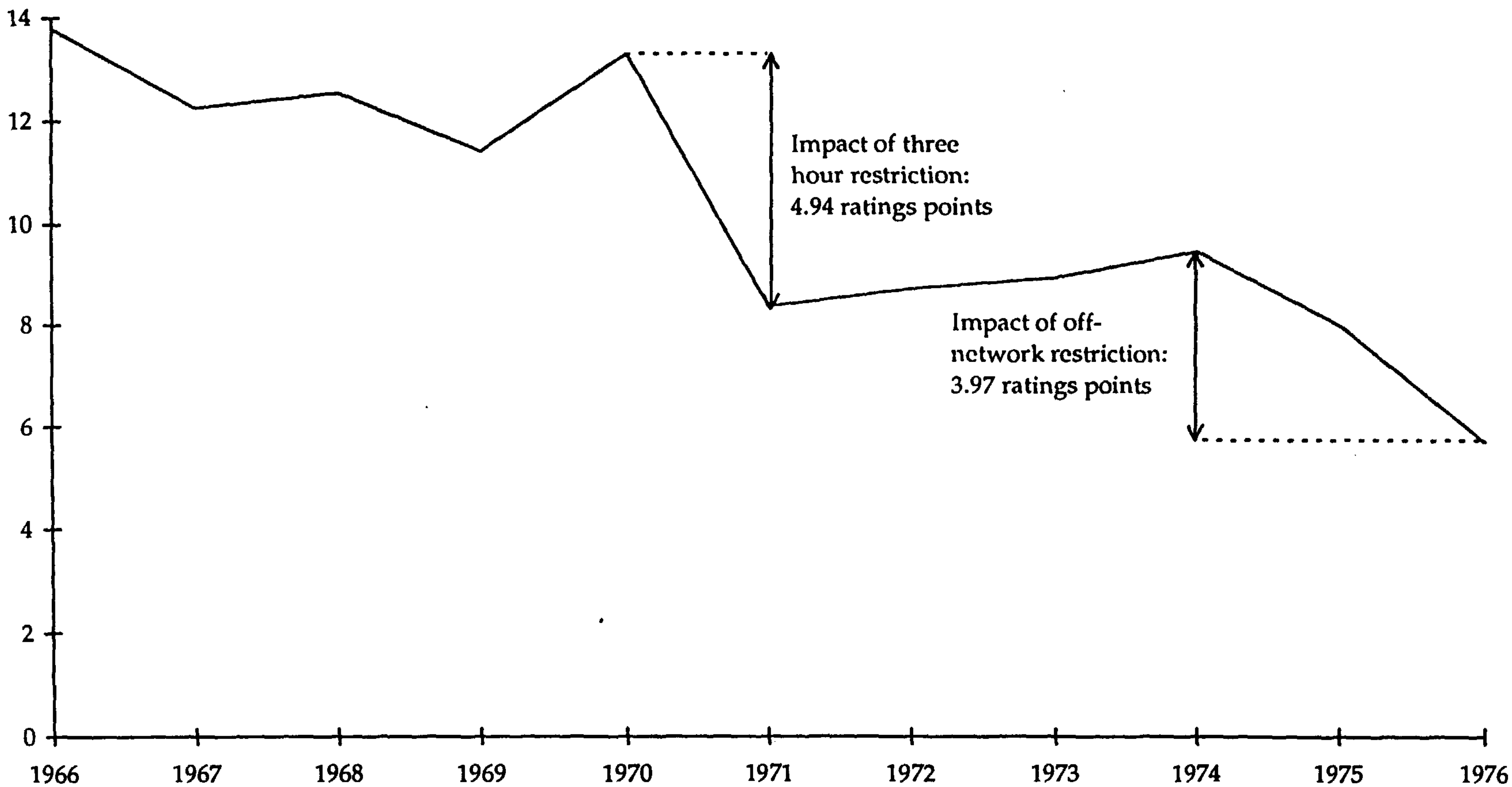
## A. THE IMPLEMENTATION OF PTAR HAD AN IMMEDIATE AND DRAMATIC POSITIVE IMPACT ON MARKETS AT ISSUE, AND REPEAL COULD HAVE AN IMMEDIATE AND DRAMATIC NEGATIVE IMPACT ON MARKETS. LECG'S PREDICTED RATINGS LOSSES HAVE VERY TIGHT CONFIDENCE INTERVALS.

To date, no party in this proceeding has challenged at all LECG's primary finding in its March 7, 1995 Economic Report. The implementation of the Prime Time Access Rule (PTAR) in 1971 had an immediate and dramatic impact on the viewer ratings of the UHF - based independent television sector. That finding was depicted in its most dramatic form in Figure IV.1 of our previous report, which we reproduce here as **Figure I-1**.

When all is said and done concerning the contradictory positions and evidence offered by opposing parties in this proceeding, the implication of **Figure I-1** is clear insofar as the possible repercussions are concerned if PTAR were to be repealed. Repealing PTAR is likely to have an immediate and dramatic adverse impact on the ratings of independent television stations. The

**In the short-run, the "three hour" and "off-network" restrictions reduced the economic disadvantage of independent stations relative to affiliates by approximately 5 ratings points and 4 ratings points, respectively.**

**Short-Run Effects of PTAR on Ratings Point Differential Between Independent and Affiliate Stations, 1966-1976**




Note: Ratings are averages based on the total stations/number of cities available.

Source: Arbitron Television Market Report, 1966-76, for markets 1-30.

Figure I-1

intuitive belief of some parties that repeal would be met by inertia is just that --a belief unsupported by any rigorous empirical analysis. Until LECG's March 7, 1995 report was released, it was also the belief of many that PTAR when implemented only had a gradual and cumulative impact on various markets.

The major additional evidence we introduce here to support our predictions of the effect of the repeal of PTAR are a set of 95% confidence intervals built around the best point estimates of ratings losses to independent stations following repeal. These are presented in **Appendix A** and discussed in **Section II.A** of this report. In short, the confidence intervals establish without question that our predictions are robust. Very few of the confidence intervals include a positive or zero impact from the repeal of PTAR. Thus, we can say with great certainty that repeal of PTAR will adversely impact the ratings of the independent sector.

### B. THE OFF-NETWORK PROVISION OF PTAR HAS HAD AS IMPORTANT A <u>MEASURED</u> EFFECT ON INDEPENDENT STATION RATINGS AS THE THREE HOUR RESTRICTION, AND REPEAL OF IT WOULD HURT SOCIAL WELFARE BY THE ONLY TANGIBLE MEASURE OF CONSUMER WELFARE: VIEWER RATINGS POINTS.

**Figure I-1** also makes it clear that each provision of PTAR, considered separately, had a positive ratings impact on the independent television sector. Despite assertions to the contrary made by Disney's economists in their reply comments, LECG did analyze the impact of the off-network restriction as well as the impact of the three hour restriction. Further, most of our analysis of the impact of PTAR on the syndicated program market focused on the off-network provision, and the implications of its repeal, as distinct from the repeal of the entire Rule or just the three hour restriction. Subtleties in our original report, such as recognizing that the three hour provision impacts all ADI markets rather than just the top 50 ADI markets, seem to have been lost on critics even though we built much analysis around the fact.

In **Section IV** of this report, we offer a comprehensive cost - benefit welfare analysis of the implications of repealing the off-network provision.

### C. ABSENT A COMPLETE DATA SERIES FOR THE 1980S (WHICH NOBODY HAS INTRODUCED), LECG'S ECONOMIC REPORT AND THIS SURREBUTTAL ARE THE MOST COMPLETE AND OBJECTIVE ECONOMIC ANALYSES INTRODUCED IN THIS PROCEEDING TO DATE.

The data set and analysis introduced by LECG in its March 7, 1995 report are the most comprehensive analytical record introduced by any party to date in this proceeding.

Critics of the LECG report assert that because our data series included only three years for the "long run", 1979, 1987 and 1993, that our predictions of the impact of repeal do not capture the "major structural changes" that this industry experienced in the 1980s. We respectfully, but completely disagree. We assembled what amount to "snapshots" of the major structural changes, rather than a "movie". Economists refer to this type of analysis as comparative statics. While we do not capture every frame of the movie, we do capture and are able to isolate the universe: (1) just before those structural changes occur; and (2) after they have largely or fully worked themselves out. Our years were chosen carefully and deliberately to isolate almost all we could know about the impact of these structural changes, short of a complete time series.

Furthermore, our three years of data capturing structural changes build those changes into our model using a large expanse of data for each year -- some thirty markets with one or more independent television stations for three time periods. Thus, while we had three snapshot years for the "long run" analysis, we did collect and analyze a great deal of data about the impact of structural changes on the markets: cable penetration, measures of UHF penetration, socioeconomic changes, and the emergence of the Fox network.

Some of our critics, notably Economists, Inc., asserted that we left out key structural changes such as the increase in the demand for advertising, while others, notably Williamson and Woroch, argued that we neglected structural changes such as the FCC's liberalization of UHF spectrum allocation. With regard to the former claim, the increase in advertising demand was also stimulated by PTAR, so it is far from clear that it is an independent structural change. With respect to the latter claim, it is the demand for additional independent television stations by prospective entrants, in light of PTAR, that likely caused an increase in the number of stations. Again, it is unclear that this is an independent structural change, or that we have not already captured its effect in our cable penetration variable.

The overriding point is clear, however. Even accepting our critics' complaint that we did not present an analysis based on a continuous time series, no other party in this proceeding has presented such a time series.

### D. THERE ARE EFFICIENCY AND DIVERSITY ISSUES AT STAKE WHICH CALL FOR LEAVING PTAR FULLY INTACT.

Many of the criticisms directed at the LECG report sought to ignore the substantial efficiency arguments we introduced in support of retaining PTAR. Williamson and Woroch argued that we were opting for indefinite "protectionism" of the independent television sector, while Economists, Inc. argued that everyone knew all along that PTAR was a "blatant" subsidy to the independent television sector.

Just who is exhibiting protectionist tendencies over the PTAR issue? The major broadcast networks calling for repeal are seeking thereby to protect their monopoly rents in the national prime time advertising market. The repeal of PTAR will, without question, raise entry barriers to new networks. To argue that PTAR is a blatant subsidy requires Economists Inc. to claim that in the absence of PTAR, there will be a competitive marketplace in 1995. There will not be. PTAR is a corrective for imbalances in the broadcast and programming markets that are the result of the inherent technical and economic disparities between UHF and VHF stations and the limited supply of VHF licenses due to past regulatory decisions.

## II. LECG's Long Run Entry Model Is Correctly Specified and Robust In the Face of Straw Man Arguments Introduced by Economists Incorporated (EI) and Williamson and Woroch (WW)

### A. Introduction And Summary

#### 1. Our <u>Ratings</u> Equations and Basic Theory Establish Our Conclusion that PTAR Has Stimulated Long Run Entry by Independent Stations, the Seed Corn for Emerging Networks

Economists Inc. (EI) go to a great deal of trouble to set up a straw man in Section II.B of their reply comments submitted May 26, entitled "Growth of Independents" (pp. 8 - 15). They assert that LECG's growth equations are the basis for our conclusion that PTAR stimulated long run entry by independent television stations. They are not! The basis for our entry argument is the <u>ratings equation</u> we specified combined with standard microeconomic theory.

On the other hand, Williamson and Woroch (WW) -- the former known for research on the theory of the individual firm -- set up a straw man by looking for our structural model to fully explain the individual independent television station's performance.[1] Seeing none, they critique LECG's economic report for not having any rigorous grounding in structural models and an economic theory of the firm appropriate to these circumstances.[2] Our ratings equation and the standard microeconomic theory of entry by firms under conditions of low barriers to entry lead us to conclude that WW missed the forest for the trees in our original report.

1 Williamson and Woroch (1995), p. 23.

2 <u>Ibid.</u>, p. 22.

WW criticize the LECG ratings equations, both historical and forecast, because we did not provide any confidence intervals. Providing such confidence intervals is not standard econometric procedure in regulatory or applied academic work. Nonetheless, we have provided these in **Appendix A**. The 95% confidence intervals are extremely tight bands around our original point estimates of the ratings impact on independent stations from implementation of PTAR and repeal of PTAR. (See **Table A-6** through **Table A-8** in **Appendix A**.)

In his response to EI.8 in **Section II.B** below, Dr. Hartman notes that EI grossly mischaracterized our treatment of Fox versus non - Fox independent stations in drawing the false conclusion that the LECG model shows PTAR had no long run impact on the ratings of independent stations. It is true that in our original report we did define the long run period as encompassing data for 1987 and 1993. In the latter year, the Fox network was programming a considerable amount of prime time fare Monday through Friday. However, in 1987, at its inception, Fox was not airing any network programming Monday through Friday during prime time.

It is possible to test EI's assertion that in our ratings equation, we confused a PTAR effect with what they believe is in fact a Fox effect. We did this by re-running our regressions stripped of the 1993 data. In essence, we still have two long run years represented, 1979 and 1987. And this enables us to correct for other structural changes in the market such as cable penetration. Eliminating the Fox network effect on independent stations ratings for the long run, we find that PTAR has had a strong and statistically significant impact on ratings. In Dr. Hartman's words:

> "And notice that now that we have dropped those observations that could involve a Fox effect, our measure of the long run effect of PTAR during the access period has increased 6%, from 0.034 to 0.036."
> **Section II.B** below

When all the evidence is in, the major problem our critics appear to have had with our ratings equation and entry story is that it is clear and compelling. Indeed, while the thrust of EI's reply comments was to deny our entry story by focusing on one of our growth equations rather than the ratings equation that does tell our entry story, WW conceded throughout most of their reply comments that PTAR did stimulate the ratings of independents and did stimulate entry.[3] And, when EI actually did focus on our ratings equation albeit not in the context of the long run entry issue, they conceded PTAR did indeed influence the ratings of independent stations.[4]

### 2. Our Growth Equations Establish Boundaries for the Timing of Entry and are Completely Misrepresented by EI and WW

Having set up a straw man on entry with our growth equations in their reply comments, EI next attempts to shoot it down. There is just no other way of describing this effort than as simply disingenuous. EI looks at our worst case upper bound scenario that PTAR led to net growth in the number of independent stations after the year 2000, while totally ignoring our lower bound estimate (and econometrically preferable specification) that PTAR led to a net increase in the number of independent stations shortly after 1980.

3 Williamson and Woroch (1995), pp. 21 and 31.

4 Economists, Inc. (1995), pp. 6 and 16.

Importantly, LECG's growth equations had very little to do with our conclusions that PTAR stimulated long run entry by independent television stations in the 30 ADI markets we sampled. It is the average-independent-station-ratings specification of our dependent variable in our ratings equation that was our primary test of long run entry, not our growth equations. Our growth equations were simply designed to test when the long run may have kicked in, not whether the incentives for entry under the PTAR stimulus existed. Clearly, our ratings equations establish definitively that PTAR did engender strong incentives for long run entry. Our growth equations, properly interpreted and weighed, suggest that this effect probably began in the early 1980s.

The reader is referred to **Section II.B** for a more complete assessment of EI's and WW's critique of our growth equations, especially Dr. Hartman's response to EI.1. Here, we show as **Figure II-1** and **Figure II-2** the growth curve of independent stations under our linear and logit model forms. Both forms replicate the finding in our statistical comparison of means that there was a very small drop in the number of independent stations immediately following enactment of PTAR, from 2.0 in the 1966 -1970 period, to 1.92 - 1.96 over 1971 - 1973 and 1.84 in 1976. Neither of these immediate post-PTAR figures are statistically different from 2.0, a fact EI conveniently omitted from its diatribe. The linear form of our growth equation so exaggerated the historical comparison of means in fitting the data that we also estimated a logit form. We chose to report both equations as a matter of procedural integrity in being independent experts before this Commission, not because we placed equal confidence in each equation. We trust the record is now corrected.

**FIGURE II-1**

**NUMBER OF INDEPENDENTS AS PREDICTED BY VARIATION IN THE TREND VARIABLES, LOGIT SPECIFICATION**

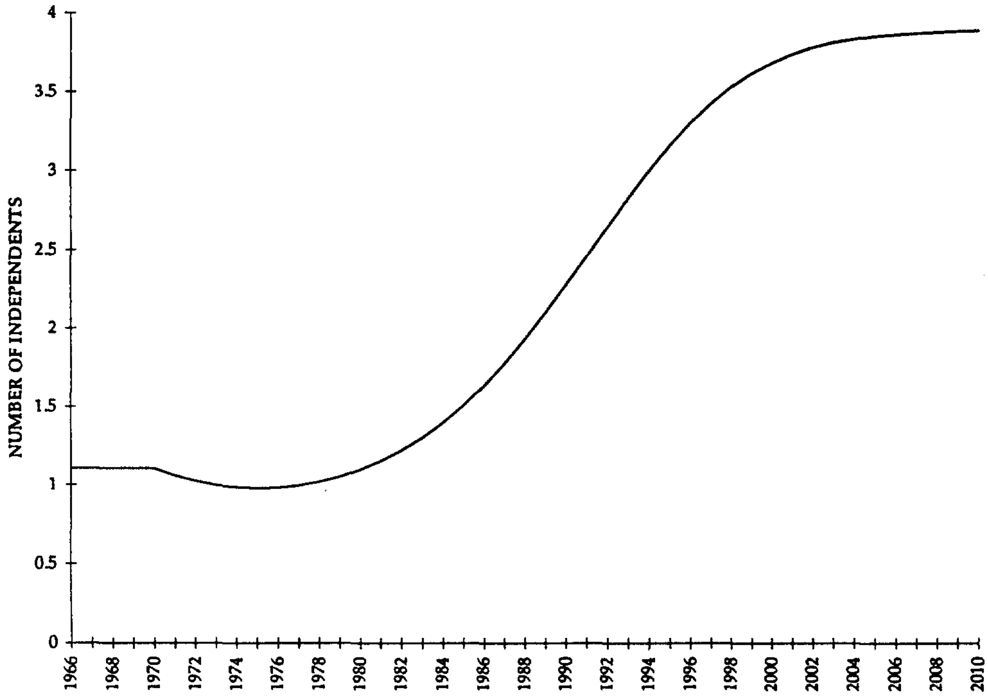
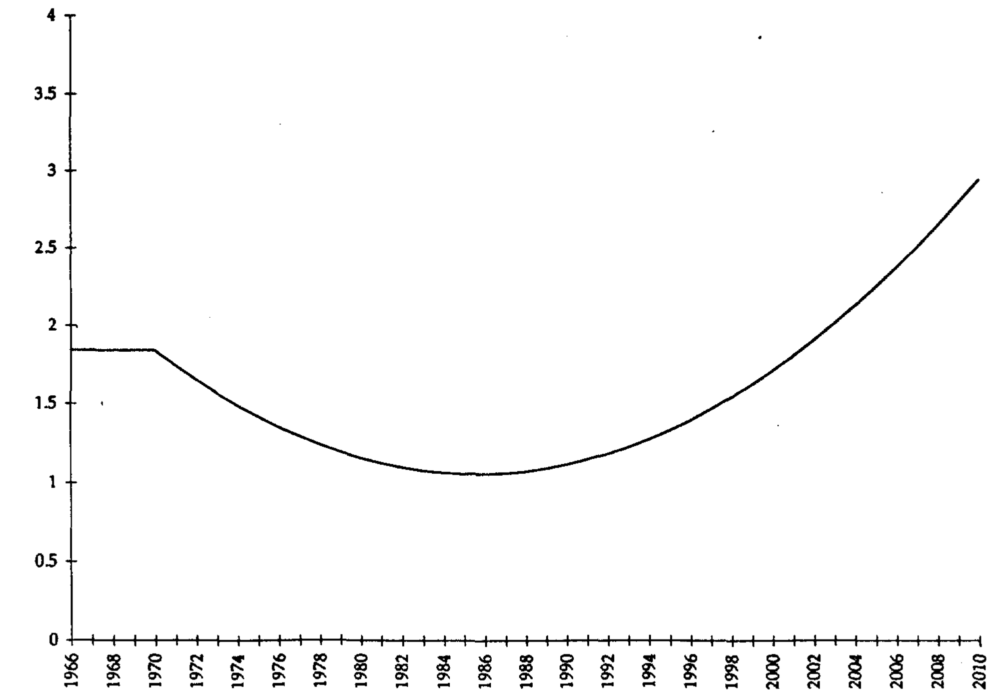



**FIGURE II-2**

**NUMBER OF INDEPENDENTS AS PREDICTED BY VARIATION IN THE TREND VARIABLES, LINEAR SPECIFICATION**



## B. RESPONSE TO THE REPLY COMMENTS OF ECONOMISTS INC. (EI) AND WILLIAMSON AND WOROCH (WW) CONCERNING ECONOMETRIC ISSUES[5]

### 1. Overview

In their reply comments, Economists Inc. (EI) and Williamson and Woroch (WW) criticize many, if not all, of the statistical methods and conclusions reached by LECG in our Economic Report, "The Economic Effects of Repealing the Prime Time Access Rule: Impact on Broadcasting Markets and the Syndicated Program Market". In this surrebuttal report, we demonstrate that their objections are seriously flawed.

In our original report, we demonstrated that The Prime Time Access Rule (PTAR) did have a statistically measurable and positive impact upon the economic performance of independent stations over the 1971-1976 period and throughout the 1971-1993 period. In **Section B.2.b** below, we provide quotations from the EI and WW rebuttal reports that indicate that they would expect such a finding.

If we may take EI and WW at their word regarding this overall positive impact of PTAR, then we believe it is fair to say that they disagree with us on the details of econometrically estimating the net impact of PTAR.

Such econometric questions are fairly raised. We respond to them in **Section B.3**. We begin **Section B.3** with a discussion of the underpinnings of our econometric analysis, which was designed to give greater clarification and

5 **Section II.B** and **Appendix A** are written by Dr. Raymond S. Hartman.

specificity to our statistical analysis discussed in **Section B.2** below. We then cite each and every criticism raised by EI and WW. We show that these criticisms are seriously flawed and substantially without merit.

In **Appendix A**, we recapitulate and re-examine our econometric findings and present additional analysis developed in response to the EI and WW criticisms.

### 2. Assessment of the Overall Impact of PTAR

As stated in our original report, a primary purpose of the May 4, 1970 FCC order enacting the Prime Time Access Rule (PTAR) was to create an environment in which independent television stations would improve their economic performance, and thereby prosper and grow.

In our report we used both statistical and econometric methods to investigate whether PTAR did indeed foster such an environment. Both analyses focused on the top 30 U.S. markets ranked by size and examined performance pre- and post-PTAR. We focused upon the top 30 U.S. markets because the majority of our data came from 1966-1976, and there were very few independent stations outside of these markets during that period.[6]

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[6] For example, we investigated the potential availability of independent station data for the top 75 markets in the following snapshot dates: 1966, 1969, 1975, 1979, 1987 and 1993. The total number of independent stations in the top 30 markets in 1966, 1969, 1975 and 1979 respectively were 26, 42, 58 and 58. For these same years, the number of independent stations in the markets of size 31-75 were 3, 5, 2 and 4 respectively, for a total of 14 observations. Of the 10 observations from the years 1966, 1969 and 1975, the same station and the same market appeared only once in a subsequent year (WYAH in Norfolk in 1975 and 1979). For all other observations, the market and station disappeared in the subsequent snapshot date.

In our statistical analysis, which is described on pages 36-43 of Appendix D of our original report, we examined average independent station ratings and aggregate independent station ratings over these 30 markets. We compared these ratings, pre- and post-PTAR. Tables D.1 and D.2 of the Appendix summarize our findings. We demonstrate that PTAR did indeed have a statistically measurable and positive impact upon the economic performance of independent stations throughout the 1971-1993 period. The short-run and long-run implications of these findings are described on pages 41-43 of Appendix D.

We find much in the EI and WW reply comments that supports our statistical interpretations. For example, EI states "the Rule so blatantly favors independent stations, it should be no surprise that to the extent it created any noticeable effect, the effect would be favorable to such stations."[7] They go on to say that "The Rule does nothing more than introduce a distortion in the market that favors one set of broadcast stations at the expense of another."[8] We agree that the Rule aided independent stations. Indeed, our statistical analysis proves that it did. However, we object to the characterization that it "blatantly favors" those stations, and we disagree that it introduced a distortion.

Our quantitative analysis attempted to assess whether PTAR implemented market conditions favoring independent stations. Our comparison of means found that PTAR did indeed have this effect. Apparently, EI is not surprised by our statistical findings.

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7 Economists, Inc. (1995), op. cit., page 6.

8 Ibid., p. 6.